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CURRENCIES AND CREDIT MARKETS

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"Capital increases when the community produces more than it consumes. Capital decreases when the community consumes more than it produces."

Economic and Public Welfare, Benjamin M. Anderson
1949, Reprint 1979, Liberty Press, Indianapolis.

HIGHLIGHTS

We have checked the data carefully. We must conclude that the so-called recovery in the U.S. has already peaked and is fading fast. Crucially, in this letter, we present a thorough analysis supporting our daring and contrarian conclusion.

A new economic relapse would certainly come as a shocker, rocking the commodity, bond, stock and currency markets. In fact, the U.S. dollar has already reacted negatively to the disappointing U.S. GDP report for the first quarter.

Business-cycle theory and history conclusively show that there are three inter-related factors of strategic, causal importance in an economic recovery. They are necessarily present in every sustainable recovery. So far they have been mainly absent in the U.S.

The U.S. money numbers continue to disappoint. It's a fact that anaemic money growth is incompatible with a sustained economic recovery. Such a combination has never happened before.

The most unusual aspect of the current recovery has been the very feeble performance of investment spending. Weak investment implies weak consumption, and vice versa.

Crucially, the past malinvestments of the 1980s now block out the normal role of investment spending during the economic recovery phase.

In Japan, the financial excesses of the past are more likely to have been covered up than corrected. The recent stock market rally owes more to manipulation than to natural market forces.

Japanese investments and profits are in a free fall, thus ruling out any sustainable economic expansion. The record-high rise of the yen against the U.S. dollar only makes matters worse.

We expect U.S. business profits to begin a new decline before year-end. At the heart of the chronic U.S. profit problem is the causal, two-way relationship between investment and profits.

Dollar bulls fail to see that the essential U.S. monetary and market conditions necessary to attract rising capital inflows have not materialized. We expect the dollar to fall back to its former lows.

Global bond markets should be the logical beneficiary of a global economic slowdown. We continue our recommendation to find safe harbour in the bonds of the hard currency countries.

FOR WHOM THE BELL TOLLS

The bell is sounding but few hear its warning peels. The U.S. economic recovery has definitely crested. For a world that is primed on the expectation that a U.S. recovery will lead a world economic rebound, this can only mean trouble. Nevertheless, unawares, policymakers, investors, speculators and traders, certain of a continuing recovery, remain transfixed with the lure of past stock and bond market gains. After more than two years of rich profits in U.S. securities markets despite weak economic fundamentals, a buying stampede continues unabated. Emboldened by a Fed that dare not raise short-term interest rates and the cheerleading of economists chanting the wonders of a low-inflation, low-growth world, complacency is virtually immovable. Though the euphoria may have waned somewhat recently, it is surely premature yet to speak of a fundamental change in market sentiment.

We have checked the data and proofed it twice. We must conclude that this so-called recovery, sluggish and fitful as it was, is fading fast. Crucially, in this letter, we present a thorough analysis supporting this daring and contrarian conclusion.

PREOCCUPIED WITH STATISTICAL BLIPS, NOT BELLS

International organizations — the Organization for Cooperation and Economic Development (OECD), the International Monetary Fund (IMF), to name a few — governments, central banks and most economists continue to trumpet their familiar siren call: low inflation and low interest rates guarantees that an "*accelerating recovery is just around the corner*" for the U.S. The fact that record-low interest rates and a massive monetary and fiscal stimulation have proved largely ineffective in stimulating a normal U.S. economy is largely ignored and played down.

In general, there is still a complete lack of understanding with respect to the deeper structural causes of the sticky malaise that has afflicted the economies of many countries, particulary so the Anglo-Saxon and the Japanese "bubble" economies. The trusted navigation guides of many economists — mainly the popular econometric computer models — who so confidently divine a favourable economic outlook, are based on the experience of a standard postwar business cycle. But this isn't a standard cycle. While these models may pick up a clear radar image of an approaching typical recovery six months ahead, they can't see and interpret the extraordinary structural impediments to the current recovery even though the causal facts of the situation lie right underneath their very noses. Instead, the slavish preoccupation with the blips and turns of every new statistic continues.

What is obvious to most, apparently, is that the recession in Continental Europe is deepening and broadening. The favourite explanation for this development always is the stubborn interest-rate policy of the German Bundesbank. Supposedly, Germany's high short-term interest rates are even hampering the U.S. recovery by way of unduly depressing Europe's economy.

We would say it is exactly the other way around. It is only normal to expect that the European economy, after its long boom, would finally slide into a recession. That's not so unusual. What is utterly abnormal is the virtual decoupling of the international business cycle because of the U.S. economy's prolonged sluggishness. Typically, in the past, Europe tracked the U.S. business cycle.

From this perspective, the U.S. recovery's strength and sustainability is the most important variable for the world economy and financial markets. While the stock and bond markets have so far felt comfortable with sub-par U.S. economic growth due to its salutary effects on inflation and interest rates, a new economic relapse would come as a shocker, rocking the commodity, financial and currency markets.

In our view, it's time to prepare for this contingency. In diametric contrast to the bullish consensus view, we have always warned that the present U.S. recovery lacks any of the forces that contribute to the ignition of a typical self-reinforcing business-cycle dynamic.

THE ESSENTIALS OF A BUSINESS RECOVERY

Business-cycle theory and history conclusively show that there are three inter-related factors of strategic, causal importance in an economic recovery. They are necessarily present in every, sustainable recovery. They are: 1. credit and broad money growth; 2. an upswing in investment expenditures; and, 3. price-cost-profit relations and profit margins. A thorough review and explanation of each of these factors — in understandable terms — will convince readers that our conclusions make concrete sense.

THE MESSAGE OF MONEY AND CREDIT

It's a fact that U.S. money and credit growth has clearly lagged behind economic growth for more than three years. Such monetary sluggishness is simply unprecedented. What's worse, during the last four months, broad money has virtually fallen off a cliff. For the first time since the 1930s, growth in broad money has actually contracted. Even M1 growth, which had soared in the second half of 1992 at an annualized pace of 15%, has abruptly slumped to a lacklustre pace of only about 3%.

Curiously, despite the diving money numbers, we see much more worrying about an impending inflation flare-up than we do about recession and deflation. Why is that? We see three main reasons: first, the combination of the Fed's aggressive monetary easing and the mammoth federal budget deficit; second, a general conviction that the U.S. economy is definitely on a sustainable recovery path; and third, the widespread and smug belief that money today matters much less than in the past.

Mr. Greenspan himself has promoted the comforting view that anaemic U.S. money growth is of little or no importance for economic growth, arguing that it is due to two strongly distortive influences. One cause is attributed to the secular decline in the share of total lending by banks and thrifts and the other cause, supposedly, is the stampede of investors into stock and bond mutual funds out of low-yielding deposits.

While it may appear plausible to Mr. Greenspan and many others that anaemic money growth is compatible with a sustained economic recovery, it's a fact that it has never happened before in history. Current experience certainly gives no reason to believe that it might be possible this time either.

It is true that an increasing portion of borrowing and lending activity is taking place outside the banking system and that this activity adds nothing to the money supply. But this explanation overlooks the fact that commercial banks perform two crucial and important functions for the economy for which there are no substitute. Firstly, banks are the economy's key source of money and liquidity; second, they are the one and only group of financial institutions that cater to the borrowing requirements of small- and medium-sized businesses. If bank lending ceases, liquidity growth ceases.

The sharp decline in bank lending over the past three years reflects something much deeper than a superficial shift in market share between bank and non-bank financial institutions. The overlying fact is that there is a most ominous shift in the entire U.S. credit structure from serving private credit to securitized government credit. It's precisely that development that the monetary statistics are manifesting. Of the total U.S. credit flow of $1 trillion in 1991-92, no less than 90% went to the government or into

government-backed mortgage bonds. Private credit, which primarily finances production, has been virtually non-existent.

THE IMPACT OF CONTRACTING MONEY

Critically, what are the causes and implications of the recent and unusual contraction of broad money? How can so much money suddenly disappear? How can it happen without adversely impacting the economy and the markets? Does money matter at all? To answer the last question first, of course, money does matter. A money contraction is bound to hurt both the economy and financial markets. But, how can money actually contract? In principle, money can leak out of domestic circulation in three ways, no more, no less. Money supply can shrink due to a worsening credit crunch on the part of banks and thrifts, through rising tax payments, or capital flows out of the country.

As for a credit crunch, the evidence we see points to a clear worsening. The expansion of bank credit, either through loans or bond holdings, has abruptly stalled. After having expanded at an annualized rate of $120 billion for a number of years, credit growth has suddenly slowed to a level of barely $25 billion. That makes for an annualized growth rate in bank assets of a measly 1%.

This new slide in bank credit is the obvious chief cause of the latest money contraction — definitely the worst in living memory. Changes in the supply of broad money come mainly from corresponding variations in bank loans and investments. Higher tax payments, due to the 1992 tax withholding changes, and rising capital outflows may also be supplementary, though minor, causes.

Putting it mildly, such an outright money contraction is absolutely contrary to what has regularly occurred when an economy recovers from a slump. Still, as indicative as it is, money isn't the main reason why we have persistently disputed the validity of U.S. recovery forecasts. After all, it has happened before that money and credit have suddenly spurted.

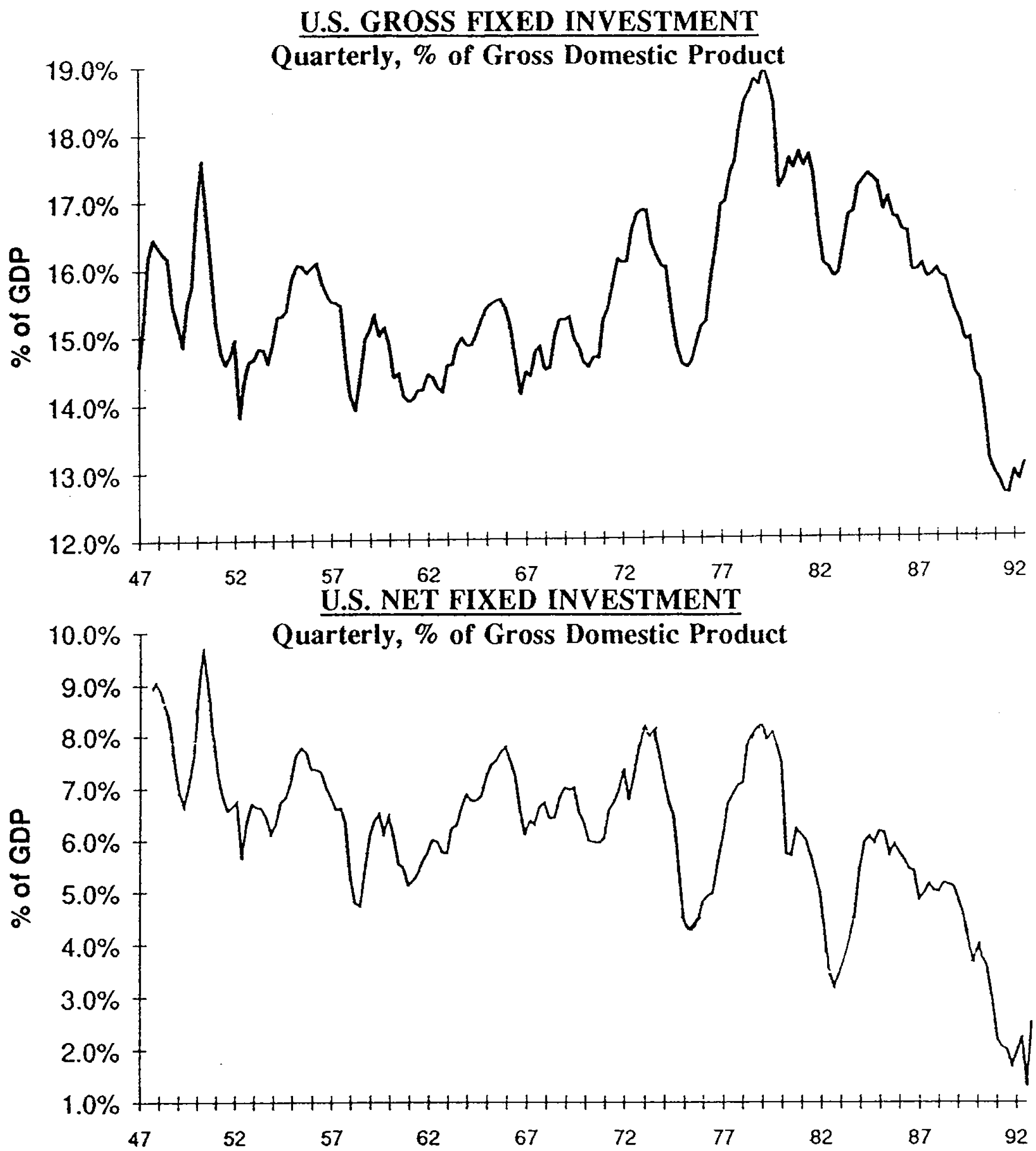
THE IMPEDIMENT TO A KEY BUSINESS CYCLE DYNAMIC

What chiefly leads us to the view that the U.S. recovery will soon fizzle out, is the fact that the present economic and monetary malaise in the United States and a host of other countries has deeper roots than just the well-known debt problems. The complacent consensus completely ignores the severe structural maladjustments in the real economies that have accrued from the credit and debt excesses of the past decades. The after-effects of these excesses now depress the economies in addition to the debt problems.

Although we want to focus on the U.S. case for the moment, credit and debt excesses have had different outlets in different countries. For example, the U.S. experience was different from that in Japan. The nature and type of "real" maladjustments were a function of where the inflated credit and money supply found its outlet. We'll focus on Japan's situation a little later.

ANGLO-SAXON CONSUMPTION INFLATION . . .

The two charts on the opposite page bare the fatal Achilles' heel of the U.S. economy. They clearly reveal the mortal damage inflicted by the debt excesses of the 1980s on the warp and woof of the U.S. economy. Capital formation was ravaged as never before; the gross and net investment ratios collapsed to the lowest levels since the Great Depression. U.S. net investment (gross investment less the



Source: U.S. Bureau of Economic Analysis, CCM

depreciation of existing fixed assets) is by far also the lowest in the industrial world. Chronic structural weakness in investment has trapped the U.S. economy — and many others — in a slow growth malaise for years to come.

The main culprits behind this massive slump in capital formation in the U.S. were the ballooning budget deficit and a runaway asset price inflation in the 1980s. By inflating consumer wealth, both of these forces served to boost consumer borrowing and consumption at the expense of savings. As savings collapsed, consumption correspondingly soared as a share of GDP and crowded out investment. What happened, in effect was that America consumed its capital, breaking down and attacking the muscle tissue of its economy, much like in an undernourished human body.

The sharp decline in the U.S. investment ratio is ominous enough since it implies very low productivity growth in the future. But the big immediate problem it presents for the current so-called recovery is a weakened role for the consumer. The past consumer borrowing binge drove spending to unsustainable levels in relation to current income. Borrowing always has its limits. Sooner or later there comes the point where the consumer has to cut spending back to match current income growth. Doing so, it deepens and prolongs the recession and essentially curtails consumer income growth even further. As such, a virtuous cycle of spending and borrowing switches over to a vicious circle of spending retrenchment and slumping incomes.

As this type of cumulative contraction process begins, bloated consumer industries begin to fall victim. Stimulated by the fat profit margins and strong revenue growth created by the long consumption boom, these industries responded with an investment boom, expanding the capacity of goods and services that catered to the consumer's consumption binge. While the capital goods industries shrank, the whole range of consumer industries overexpanded on the expectation that consumer demand would continue its advance forever. A large portion of these past investments now turn out to be malinvestments. As the consumer retrenches, companies discover that there is way too much capacity in such things as hotel rooms, restaurants, retail merchandising space, airline seats, consumer durable goods manufacturing capacity, leisure industries . . . to name only a few.

There also is a direct link between real estate and overconsumption. Consumer-related industries — especially the service industries — tend to be real estate intensive. The consumption boom therefore also contributed to an overexpansion in commercial real estate. Britain, Canada and Australia experienced very similar kinds of structural distortions as did the United States. Overconsumption fuelled the same kinds of related malinvestments. Crucially, these malinvestments now block out the normal role of investment spending during the economic recovery phase. Rather than investing at this stage, many industries are shrinking and disinvesting instead. A vast overhang of commercial real estate and stagnating consumer incomes undermine the prospects for a strong construction upturn.

What we see in all of these countries is that the investment weakness is basically of a structural nature. That explains why low interest rates have failed to show the normal stimulative effects.

. . . VERSUS THE JAPANESE INVESTMENT INFLATION

Japan experienced a very different kind of inflation. It had a most rampant inflation in stock and real estate prices. As distinct from the Anglo-Saxon countries, the maladjustments in the real economy took place overwhelmingly in the investment sphere. In Japan, you could say, consumption was squeezed down by investment spending. The main borrowers in this case were corporations financing reckless financial speculation and capital spending in real estate and industrial expansion. There was virtually no government budget deficit. If the Anglo-Saxon countries grossly overextended their consumer spending structures, then Japan grossly overextended its entire industrial base.

Accordingly, the corporate and industrial sector is where the primary collapse is now taking place in Japan. Investments and profits are in a free fall, thus ruling out any economic expansion in the foreseeable future. Corporate debt levels are at record highs — three times the respective U.S. levels — and profit margins are at record lows. Many look at Japan's record high export surplus as a sign of economic strength. Given virtually stagnating exports, what the trade surplus really reflects is economic weakness since it is shrinking domestic demand that is reducing imports.

The strong rise in the yen against the U.S. dollar, soaring to a record high, can only make things worse. The Japanese government has responded to the economic weakness by announcing a huge new spending stimulus amounting to more than $100 billion. Whether or not this action will stabilize or even revive the Japanese economy, remains to be seen. Recently, some monetary indicators in Japan have stopped falling, perhaps signalling a temporary bottoming in the economy. However, rising under-utilization in industrial capacity and cost cutting by corporations remain strong depressants. So far, the financial excesses of the past in Japan are more likely to have been more covered up than corrected. The recent stock market rally, in our view, owes more to manipulation than to natural market forces. Given the plunge in profits, valuations are again at astronomic levels even though stock prices are still 40% below their late-1989 peak.

THE RECOVERY ROLE OF INVESTMENT

It is common in America to hear of a business revival being sparked by the consumer. Though it's widely thought that this is how an economic recovery is born, it is utterly wrong. In the U.S., just as everywhere else, business cycles have always been led by a burst in investment spending — particularly residential building and inventories. To understand the present predicament in the U.S., one needs to appreciate the crucial and dynamic role that investment plays in the business cycle.

A key thing to realize is that the standard business cycle was always mainly a function of the inventory cycle. That explains why business expansions were always relatively short — roughly three to four years — interrupted by downturns of less than a year in length. The Depression of the 1930s was the first exception to this pattern in this century. In the case of the U.S., the deep slump of the 1930s originated in a steep, prolonged fall in fixed investment and consumption. Inventories, by contrast, only played a very minor role during this period. The present situation bears a striking resemblance to that of the 1930s.

The table on the next page illustrates the precarious nature of the current U.S. recovery by pinpointing two crucial differences with past business recoveries. The first aspect that differs fundamentally from all the postwar predecessors in this recovery is its aggregate weakness. During the first four quarters of expansion, U.S. GDP this time grew 1.6%, as against an average of 7% in all other postwar cycles. Taking the first two years, cumulative GDP growth normally totalled an average of 12%. This time, growth only amounted to a poor 4.5%, a little more than a third of the previous average.

The second big abnormality that is evident is the composition of growth. During the first year of the seven postwar cycles, investment spending averaged 110.5% of GDP growth during the first year and almost 50% of GDP growth during the first two years. The most remarkable and unusual thing about the current recovery right from the beginning is the extremely feeble performance of investment spending. Weak investment implies weak consumption, and vice versa. That's what the sluggish money and credit data correctly reflect.

To repeat and conclude: Business recoveries are typically ushered in by rising investment expenditures. As investment soars, it raises employment and incomes in the building and capital goods industries which in turn increases consumer spending by a magnified amount. These industries are labour and income intensive. Investment, in the Keynesian language, impacts the economy with powerful multiplier effects on employment and incomes. Conversely, it also implies this outcome: If investment spending fails to take the lead, any recovery will soon sputter and fade. Exactly that is what we predict for the present U.S. recovery. The only question that's open is the extent of the impending downturn.

DEMAND COMPONENTS OF PRESENT AND PAST U.S. ECONOMIC RECOVERIES

	First Year of Recovery			First Two Years of Recovery		
	Cumulative One-Year Growth	Average Growth\ Quarter	Attributable to GPI	Cumulative Two-Year Growth	Average Growth\ Quarter	Attributable to GPI
Average of 7 Postwar Recoveries (ex. 1980, 1945)						
Gross Private Investment (GPI)	29.5%	6.6%	110.5%	34.0%	4.0%	49.6%
Personal Consumption	5.7%	1.3%		9.5%	1.2%	
Gross Domestic Product (GDP)	7.0%	1.7%		12.0%	1.4%	
1991 Recovery (2Q 1991 to end 1Q 1993)						
Gross Private Investment (GPI)	3.5%	0.9%	40.5%	20.2%	2.4%	66.5%
Personal Consumption	2.0%	0.5%		4.5%	0.6%	
Gross Domestic Product (GDP)	1.6%	0.4%		4.5%	0.6%	

Source: U.S. Bureau of Economic Analysis, CCM

PROSPECTS FOR PROFITS

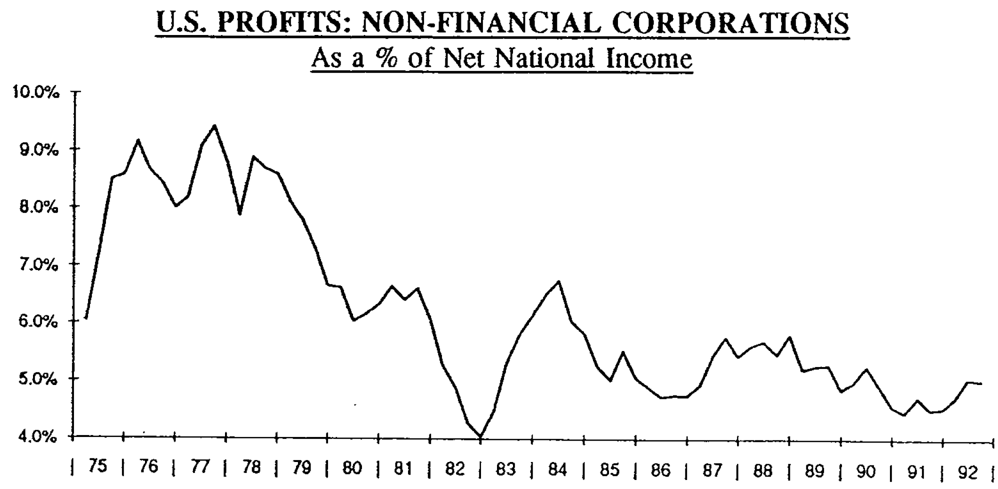
Earlier, we said that our assessment of the U.S. economic outlook was premised on three strategic factors — money and credit, investment outlays and business profits. Our analysis of the first two has already shown that there is more than enough reason to conclude that this recovery is unhealthy and doomed. There is absolutely nothing in sight that could induce a powerful wave of investment in fixed assets and propel the economy ahead during 1993 or 1994.

The one thing that could potentially make us less negative is a strong rise in business profits. Profits are up 28% over year-ago levels according to government statistics. That makes Wall Street bullish. But really, let's examine where these profits are coming from. To start with, the profit improvement must be seen to be modest as compared to past business cycles. Even so, most of the profit gain can be attributed to two non-recurrent sources: a steep fall in interest rate costs and the indirect effects of the huge rise in the budget deficit. The key point to realize is this: both of these incremental sources of profits are now largely at the end of their respective ropes. Interest rates are not likely to fall much further and the budget deficit is already large. From here on, profits can only decline.

Here too, it is important to see the short-term profit trend in the context of the dismal long-term picture as illustrated in the chart on the opposite page. Profitability of the U.S. corporate sector has been lagging for most of the past 20 years. At the heart of the chronic U.S. profit problem is the causal, two-way relationship between investment and profits. Low investment depresses profits, and low profits depress investment. Once these two reinforcing trends have become entrenched, it's very difficult to reverse.

MARKET REACTIONS

All three business cycle factors conclusively point to an impending U.S. downturn. When this happens, how will the markets react? The pace of U.S economic growth has already slowed substantially from the



4.9% pace of last year's fourth quarter to only 1.8% in the first quarter of 1993. So far, there seems to be more surprise and disbelief than shock. Yet, the first visible casualty already is the dollar. After hitting a peak of almost DM 1.67 in early February, it has since given up 10 pfennig against the D-mark, or more than one third of its previous gain. What makes this all the more remarkable is that it happened despite repeated German interest rate cuts. A narrowing of the short-term $/DM interest rate differentials was the main argument of the dollar bulls. Nonetheless, most reports that we read are hardly less exuberant on the U.S. dollar than before.

What foiled the dollar bulls is the still-born U.S. recovery. Their second mistake — a less excusable one — was to think that the dollar would soar on the strength of a declining short-term $/DM interest rate differential alone. This latter mistake really betrays a poor comprehension of the forces that have driven the dollar's cyclical upswings in the past.

Actually the dollar has always surged versus the D-mark when a U.S. economic recovery coincided with the advent of a recession in Europe. The basic reason for the regularity of this phenomenon is that under such conditions, the rebounding U.S. economy tends to attract a rapidly rising tide of foreign capital. Usually, these inflows are largely in the form of Euro-dollar borrowings (offshore borrowing of dollars) by U.S. banks and corporations and partly in the form of investment portfolio inflows.

Convinced that history must repeat itself, banks, corporations, fund managers and speculators — virtually the whole financial world — loaded up with dollars late last year, thereby driving it from DM 1.39 to nearly DM 1.67. What they failed to see was that, for various reasons, the essential monetary and market conditions for rising capital flows never materialized on the U.S. side. Nor, as explained, is there any chance that such conditions will develop in the near future either.

The 1982-83 period is worth remembering in this regard. After the monetary squeeze of Paul Volcker, U.S. stocks and bonds soared from extremely depressed levels, while banks and corporations made heavy use of the Euro-market to meet their sharply mounting financing requirements. Today, record-low U.S. interest rates converge with record-high stock valuations and rich bond prices while banks and

corporations have no need for additional borrowing at home let alone abroad. Actually, to the contrary, banks are shrinking their balance sheets.

What clearly sparked the dollar's ascent late last year was speculation, not investment. After all, it should be obvious that America's huge budget and trade deficit combined with its aggressive monetary ease and extremely low credit demand are a sure recipe for a weak dollar over the long run.

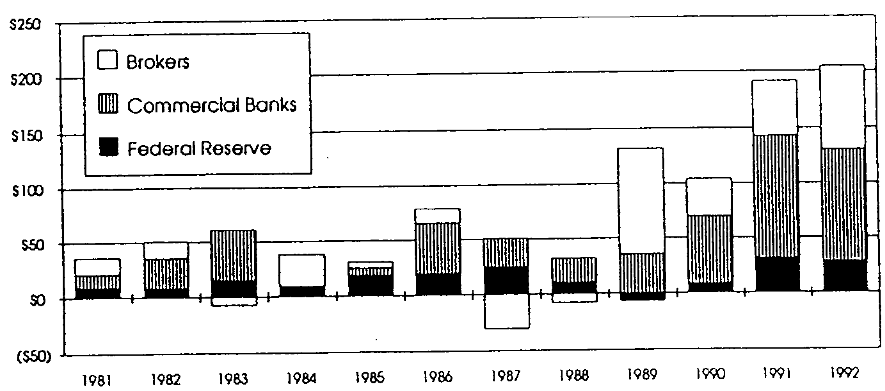
We can only repeat our earlier forecast: The dollar will fall back towards its old lows because the conditions for its well-predicted bull-run are absolutely non-existent. A lot more than just a narrowing of interest rate differentials is required to heave the dollar up to the dollar bulls' target of DM 1.80-2.00.

BOND BUBBLE BELLS

In past letters, we have often pointed to the rampant speculation building up in the U.S. bond market. Banks, brokers and financial institutions have been financing a huge and rising stockpile of government bonds with cheap short-term borrowings. The Wall Street Journal recently reported that six leading brokerage firms attributed no less than a stunning 76% of their total profits last year to playing the yield curve — borrowing at rock-bottom short-term rates and investing the money into higher-yielding medium- and long-term bonds. Apparently, their interest income earnings bounded 63% over last year's levels.

The adjacent graph gives a sense of the scope of this bond bubble. It shows the total bond purchases of the Fed, the banks and the investment brokers since 1980. Together, their common features are money creation and a high sensitivity — that is vulnerability — to any rise in interest rates. Brokers, particularly, are more highly leveraged than ever before.

U.S. GOVERNMENT BOND PURCHASES BY FINANCIAL INTERMEDIARIES
$U.S. Billions



Source: Flow of Funds, Federal Reserve

At the same time, brokers are lending more heavily than ever before to individual investors who are playing the same game with cheap margin loans. Presently, margin loans of this kind are at a record $45 billion. Apparently, by encouraging all these weak holdings of government bonds, the Fed is trying to stabilize the financial system.

As we've often said: We aren't able to guess what it might be that will eventually prick this whopping new speculative bubble, especially if sustained economic weakness allows the Fed to keep short-term interest rates at their low levels . . . or perhaps, to lower them even further. The stock market, in turn,

can be expected to track the buoyant bond market.

There are evident dangers. In the case of the stock market, a particular risk are profit disappointments. These can be expected to occur later in the year. As for the bond market, the primary risk is the staggering supply of Treasury and government agency bonds. Last year, such issues totalled $471 billion, greatly swamping the supply of only $200 billion in private savings. It's hard to believe that brokers and banks can continue their insane leveraging game for much longer. Sooner or later, they will have to scale back their purchases. Government borrowing, though, can hardly be expected to diminish. Given the rampant "bond bubble," any setback, when it hits, will be extremely severe. In this regard, the sudden, sharp contraction of broad money growth could be the warning signal.

A NECESSARY DOWNTURN IN EUROPE

While we may be pessimistic about the U.S. economy, we're not all that optimistic about Europe either. Assuredly, after a long boom period, a cooling-down phase in Europe is overdue and desirable. Since the boom was centred in industrial investment, the downturn essentially finds its centre in the same sector. Assessing Europe's outlook, the key question to address is this: How much of the downturn is attributable to structural as opposed to cyclical factors?

In general, Europe has three structural problems: rigid labour markets, excessive budget deficits, and excessive industrial investments largely fostered by the artificial exchange rate stability of recent years. Obviously, the countries with the biggest budget deficits — which also have the biggest trade deficits — like Britain, Spain, and Italy, face the greatest risks.

It goes without saying that the German economy's performance will play a key role in Europe's outlook. Presently, the gloom and doom about the terrible consequences of unification for the west German economy could hardly be worse. Admittedly, Mr. Kohl and his government offer a most pitiful picture. They miserably failed to meet the economic and psychological challenges of German unification. But the wishful thinking that a German "crash landing" will lead to rock-bottom interest rates misses one important point: At the core, the German economy still has strong and solid fundamentals.

Germany is not suffering from an Anglo-Saxon/Japanese style recession that results from speculative excesses. The one "excess" is a massive build-up of industrial capacity, largely induced by the artificial currency stability that prevailed in Europe in recent years and which led to an undervalued D-Mark. But this investment boom was largely financed with internal cash flows. Corporate profits soared during this period. No runaway consumer borrowing binge occurred as in the Anglo-Saxon countries. The personal savings ratio stayed at 13-14%, its highest level in 30 years. As well, there was no commercial overbuilding except in a few major cities. Accordingly, German banks have not suffered the property-related busts as has been the case elsewhere. In the meantime, there are vast requirements for infra-structure investments in east Germany and there is an acute housing shortage in west Germany. This is not the picture of an economy destined to a bleak future.

Germany's big problems of today stem from two sources: a loss of competitiveness due to recent strong wage rises compounded by the broad revaluation of the D-mark; and second, an explosion of the budget deficit to a level of 6% of GDP which serves to finance east German consumption and investment. Many people, apparently, overlook that this deficit has become a substitute for the former large export surplus by redirecting resources to the east and away from abroad.

CONCLUSIONS

We conclude that the world economy is heading for a synchronized downturn given the U.S. economy's impending relapse. All the normal business cycle dynamics that normally drive and contribute to a recovery phase are mainly absent in the U.S.

Although it's now commonly believed that Japan's economy and financial markets have successfully turned the corner, we think that Japan's financial excesses of the past have been more covered up than corrected. The recent stock market rally, in our view, owes more to manipulation than to natural market forces.

Our view of the prospects for the different markets — commodities, stocks, bonds, and currencies — is necessarily a function of our economic outlook. No doubt, our scenario will be negative for stocks and commodities. Easier money won't be sufficient to support stock prices over the long run.

In general, a slowing world economy will be favourable for bonds. However, there are tremendous differences in the underlying fundamentals of various bond markets and currencies. The rationale for our continuing preference for the bonds of hard-currency countries is that these economies are in fundamentally healthier shape. They have a much better balance, both internally and externally, than the weak-currency, low-savings countries.

The U.S. "bond bubble" has careened out of control, holding the Fed hostage to low, low interest rates. Any rise in interest rates, whether to support a weak dollar or for whatever reason, will trigger a severe bond market collapse.

We repeat our earlier forecast: The dollar will eventually fall back towards its old lows because the conditions for its well-predicted bull-run are absolutely non-existent.

Next Mailing: June 2, 1993

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